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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. 72-862

ERNEST E. POTTER,
Petitioner,

vs.

MOULDINGS, INC.,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Fifth Circuit

STATEMENT OF THE CASE

Respondent incorporates by reference and adopts the statements of fact contained in the opinions of the Fifth Circuit Court of Appeals (App., p. 32) and the District Court for the Middle District of Georgia (App., p. 19).

The petitioner's statement of the case contains several very basic errors which should be noted.

First, while it was not necessary for the lower courts to determine whether Potter knew, or did not know, that his Mouldings stock was restricted, there is substantial evi-

dence that Potter did, in fact, know that his shares were restricted. As the District Court Judge concluded:

> "Were it necessary for this Court sitting as a court of equity to decide (whether Potter was in fact aware that his shares were restricted at the time he delivered his certificates to Bache in November, 1969) we would have no difficulty in deciding that he did have such knowledge because such a conclusion is indicated by many circumstances" (App. p. 26).

Thus, Potter could hardly be classified as one who acted "unwittingly". The alleged 'predicament" Potter was in was of his own making.

Probably the most fundamental error which Potter makes in his statement of the case, as well as in his argument, is the assumption that he was in a position to assign the proceeds from his sale of Mouldings stock in November, 1969 ($200,385.54) to his friends (whose stock he purchased). The record is quite clear that Bache & Company ("Bache") acting as Potter's agent, and for his account, actually sold 8,000 shares of Mouldings stock on the American Stock Exchange in November, 1969 and the proceeds from these sales were promptly reinvested in other securities. Thus, there were no proceeds which could be assigned.

Potter is also wrong when he says that he arranged to "cancel his attempted sales and to transfer the sales to other persons whom he knew to be Mouldings stockholders and who would furnish unrestricted shares and receive in return the proceeds of the sales" (Petition, p. 5). The sales had already been executed on the American Stock Exchange and they were *completed*—not attempted—sales.[1]

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[1] The actual sales of Mouldings stock in November, 1969 occurred on the American Stock Exchange between Bache, as the selling broker, and other brokers who were purchasing Mouldings stock for their unidentified customers. The sales and pur-

Furthermore, the rules of the American Stock Exchange do not permit the cancellation of sales which have been executed on the Exchange, and, as a matter of fact, they were not cancelled.

Not only could the sales not be cancelled but also, as hereafter noted, Bache was unwilling to alter its records to coincide with Potter's cancellation theory; therefore the sales were neither cancelled in substance or in form.

The certified check which Potter refers to on page 5 of his petition was used by Bache to pay Potter's friends, and was not used to pay for the stock which had been purchased by Bache for Potter in November, 1969. This stock had already been paid for with the proceeds from the sale of the 8,000 shares of Mouldings stock. Potter is, in effect, contending that Bache financed the purchase by him of securities costing in excess of $200,000.00. This would have constituted a serious violation of the law and Bache would not, and did not, do this.

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chases were in no way dependent upon when, or whether, the respective brokers customers fulfilled their obligations to them. On the contrary, once a broker such as Bache executes a sale on the floor of the American Stock Exchange, the **sale** is complete and the selling broker immediately becomes obligated to deliver to the brokers who made the purchases the number of shares sold; and if the selling broker fails to deliver then the broker who made the purchases can buy the necessary shares on the Exchange and charge the cost thereof to the selling broker. The selling broker, of course, looks to its customer for delivery, and if the customer fails to deliver to it, then it can also buy the shares on the Exchange and charge its customer's account (the customer having received the proceeds from the sales). See Israels and Guttman, Modern Securities Transfers (1967), p. 603.

REASONS FOR DENYING THE WRIT

I. The Decision of the Fifth Circuit Court of Appeals Was Correct.

A. Potter's contention that the transactions were recast in a form which enabled him to avoid the provisions of section 16(b) is without merit.

Before commenting on the several theories advanced by Potter in support of his "form" argument, it should first be noted that a very basic problem with this contention is that actually nothing was done to change the form of the transactions, the "form" being the sale of 8,000 shares of Mouldings stock in November, 1969 by Bache for Potter's account, and the covering purchases of 8,000 shares by Bache for Potter's account in February, 1970. The sole basis of Potter's argument is a set of self-serving letters which Potter had his friends sign. While the letters requested Bache to "transfer the sales" which Potter had made in November to accounts which would be opened in the friends' names, Bache did not change its records to coincide with Potter's theory. Instead, Bache's records reflect the fact that the November sales were made by Potter and the 8,000 shares of Mouldings stock credited to Potter's account in February, 1970 were acquired from Potter's friends with funds supplied by Potter. Thus, there is no substance to Potter's "form" argument.

As for the specifics of Potter's contention, the Court of Appeals not only took issue with his novation argument, it summarily rejected it. This argument was based on the false assumption that Potter was in a position to assign the proceeds from the November, 1969 sales of Mouldings stock to his friends. As already discussed, this could not be done since the proceeds had not only been received, but

they had also been reinvested in other securities. There were no proceeds to assign.

Another obvious problem with the novation argument is that the sales had already been executed—they were not "attempted" sales. Bache, as Potter's agent, completed the sales in accordance with the rules of the American Stock Exchange, and Potter's duty was to Bache, as his agent, and not to the persons who actually purchased the stock on the Exchange.

There was no reason for the Court of Appeals to consider the "rescission" cases because the November sales were not rescinded. As already noted, the rules of the American Stock Exchange do not permit sales to be rescinded. Furthermore, even if the rules did authorize rescission, no rescission could have been accomplished without the participation of the persons who bought the stock. In this regard, Potter overlooks the fact that Bache did not buy his stock in November. Bache acted as Potter's agent and there was nothing that Potter, as the seller, and Bache, as his agent, could do between themselves which would have the effect of rescinding the sales. This is elementary.

The Court of Appeals "ignored" **Emerson Electric Company v. Reliance Electric Company**, 306 F. Supp. 588 (E.D. Mo. 1969), rev'd, 434 F2d 918 (8th Cir. 1970), aff'd, 92 S.Ct. 596, for the simple reason that **Reliance** involved a set of facts, and holding, not in the least bit analogous to the case under consideration.

B. **The Court of Appeals correctly concluded that the possibility of abuse test was inapplicable.**

Potter's possibility of abuse argument is based upon his contention that there was a novation which, as discussed above, there was not.

The possibility of abuse test has been applied only in those cases which involved transactions which are unorthodox, such as conversions, options, reclassifications and the like. Here, we are concerned only with sales and purchases and that being true Section 16(b) applies automatically, regardless of the insider's motives or intentions.

Although the possibility of abuse test is inapplicable, it should be noted that this was a situation where Potter could have benefited from his position as an insider.

While it was not necessary for Mouldings to show that Potter actually took advantage of inside information when he decided to sell Mouldings stock in November, 1969, the evidence strongly indicates that in all probability he did. Potter wanted to dispose of all of his Mouldings stock (except those shares evidenced by legended certificates) and almost immediately after the November sales the price of Mouldings stock dropped significantly. As an officer and director, Potter was certainly in a position to foresee what lay ahead for Mouldings stock. It also should be noted that Potter promptly reinvested the proceeds in other securities and so obviously he was worried about the future of Mouldings stock in particular, and not the stock market in general.

It is no doubt true that Potter originally did not intend to purchase any more Mouldings stock since he obviously hoped that it would not be discovered that the certificates which he had delivered to Bache represented restricted shares. However, when Potter sold Mouldings stock at a time when he did not own any unrestricted shares which could be delivered to his broker, he was assuming the risk that he would have to subsequently purchase unrestricted shares to fulfill his obligations to his broker.

As discussed in the opinion of the Fifth Circuit Court of Appeals, when Bache sold Mouldings stock for Potter's

account at a time when he did not own any unrestricted shares, Potter, in effect, was selling "short", and by selling short, he violated Section 16(c) of the Securities Exchange Act of 1934, which provides:

> "It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer . . ., if the person selling the security or his principal (1) does not own the security sold . . ." 15 U.S.C.A., Section 79p(c).

In **Silverman v. Landa**, 200 F. Supp. 193, the Court stated:

> "The legislative history of Section 16(c) makes clear that Congress was concerned with 'short sales' and 'sales against the box' as that type of trading was used by corporate insiders deriving large profits from transactions in their company's securities while they were concealing the fact that they were so engaged."

In view of the specific provisions of Section 16(c), Potter is hardly in a position to argue that this was not the type of transaction which lends itself to the preferential use of inside information. While it is true that Potter could perhaps have avoided Section 16(b) by waiting at least six months before purchasing the shares from his friends, he did not wait, and thus not only did he violate Section 16(c), but he also brought himself squarely within the provisions of Section 16(b).

It also should be pointed out that if the lower courts had accepted Potter's argument that Section 16(b) should not apply in situations such as this, an insider with unlegended stock would be encouraged to follow the same course as Potter did with the knowledge that if he got caught he could still salvage something from the transaction by paying his profits to his friends, rather than to

the corporation. The insider would have nothing to lose, and possibly a great deal to gain.

The fact of the matter is that Potter **knew** that Section 16(b) applied and that is why he paid the profits to his friends. He realized that if he had not, there would be no way at all to even attempt to prevent the profits from going to Mouldings. Apparently what he did not realize was that it is Section 16(b) and not the insider who determines where such profits shall go.

C. **The court of appeals correctly concluded that Potter realized profits.**

Since Potter clearly made sales and purchases of Mouldings stock within a six months period the final consideration was whether he **realized** profits from these transactions. As both lower courts observed, Potter controlled the disposition of a substantial sum of money and in so doing he realized profits within the meaning of Section 16(b).

On February 2, 1970, the date Bache received the certified check for $200,385.54 from Potter, it had two alternatives. The first alternative, and the one that would have been followed had it not been for Potter's express instructions to the contrary, was for Bache to have bought the stock on the American or Pacific Stock Exchanges. Had it made these purchases on February 2, it could have acquired 8,000 shares for $95,000.00 since Mouldings closed at $11.87½ on that date, and had it made the purchases on February 9, the date the purchases from Potter's friends were consummated, it could have acquired the same number of shares for $97,000.00.

If Bache had paid the market value of the Mouldings stock, which it would have done had it not been for Pot-

ter's directions, then, without question, Potter would have had to have immediately sent Mouldings a check in an amount equal to the difference between what Potter received for the 8,000 shares which he sold in November and what he paid for a like number of shares in February. There would simply have been no way for Potter to have even attempted to disguise the fact that a substantial profit was realized. Potter was well aware of this, and that is why he instructed Bache to follow the second "alternative."

The second "alternative" (and it was an alternative only because Potter made it so) was to buy the shares from Potter's friends and to pay them the same amount per share that Potter had received in November. However, the fact that Potter's friends were thus able to sell their Mouldings stock for approximately $25.00 per share **in no way changed the fact that on February 9, 1970 the actual market value of their stock was only $12.12½ per share.**[2]

It is quite obvious that what Potter was doing was giving to his friends the money ($103,385.54) he would otherwise have had to pay to Mouldings had the shares been purchased on either Exchange. Potter was thus trying to circumvent Section 16(b) by paying the profits which belonged to Mouldings and all of its stockholders to a select group of Mouldings stockholders comprised exclusively of his friends. The lower courts were correct in holding that not only did Potter not have the right to keep the profits for himself, but also he did not have the right to direct and control where they went. Partial compliance with Section 16(b) will not suffice.

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[2] The computation of profit for purposes of Section 16(b) depends on valuation which is generally determined by market value on the date of the transaction. **Newmark v. RKO General, Inc.**, 305 F. Supp. 315 (S.D.N.Y. 1969), Aff'd 425 F. 2d 348 (2d Cir. 1970), Cert. den. 400 U.S. 854.

Because of Potter, and only because of him, this select group of Mouldings stockholders was thus able to sell its Mouldings stock for more than twice its market value. Had Potter's friends been so inclined they could have immediately purchased the same number of shares of Mouldings stock which they sold to Potter and they would have retained their identical equity positions **plus** a profit of $103,385.54. This, of course, is the same profit which Mouldings should have received, and would have received had Potter not decided to pay it to his friends rather than to Mouldings.

Potter can find no comfort in the fact that he gave the profits to his friends, rather than keeping them for himself, because he realized the profits by controlling and directing where they went. Insofar as the other stockholders of Mouldings are concerned the profits which Potter gave to his friends might just as well have been retained by him. The effect on them was the same.

Section 16(b) is designed to do more than "punish" the insider who has taken advantage of inside information. As the District Court for the Southern District of New York stated in **Epstein v. Shindler**, 200 F. Supp. 836 (1961):

> "There is, unquestionably, a public interest sought to be protected by the Securities Exchange Act. But it is not the public at large which is specifically protected by Section 16(b) so much as the 'outsiders', that is, the general body of stockholders not having the advantage of inside information. The statute redresses a wrong to them by the return of profits to the corporation itself."

The wrong suffered by the stockholders of Mouldings was not diminished in the slightest by the fact that Potter gave the profits to his friends rather than keeping them for himself.

Potter is also wrong when he says that Potter never brought any profits into his possession. Potter had already received the proceeds from the November sales, and, in February, the only question was to whom he had to pay the profits. Obviously, Potter had complete control over the profits, as evidenced by the payments to his friends.[3]

The principles set forth in **Blau v. Lehman**, 173 F. Supp. 590 (S.D.N.Y. 1959) aff'd, 286 F. 2d 786 (2d Cir. 1960), aff'd, 368 U.S. 403 (1962), are applicable. In **Blau**, the District Court stated:

> "If his waiver was effective to transfer his share of the profits to his partners, then it is clear that by making such transfer of profits he was disposing of profits and to that extent he 'realized' the profits." Id. at 595.

In a footnote, the Court observed:

> "For taxation purposes income has been held to be 'realized' when it is made subject to the will and control of the taxpayer, and could be, except for his own action or inaction, reduced to actual possession. (Citation.) See also **Helvering v. Horst**, 1940, 311 U.S. 112, wherein realization of income was defined as the power to procure payment to another." Id. at 595, f.n. 2.

One additional point which should certainly be made is that if an insider were at liberty to buy stock at whatever price he saw fit, a vehicle for gross abuse of Section 16(b) would be available. To illustrate, an insider might perceive that the company's stock was going to decline, and for

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[3] Where stock is first purchased and then sold, the insider receives the profits when the sales are executed; however, when the sales precede the purchases the profit must be measured by the difference between the amount received when the stock was sold, and the cost of the stock when the purchases are made. The insider, of course, does not receive the profits in the form of cash at the time the purchases are made.

that reason it would be advisable to sell, yet at the same time he might want to retain his equity position. Under Potter's theory, the insider could sell his stock, and then buy stock back from friends and family and pay the profits which would have gone to the company to his friends. (His actions would have created a profit based upon the difference between the proceeds received and the market value of the stock subsequently purchased). In such a situation, the insider would obviously derive substantial indirect benefits, and in many instances he might receive direct benefits in the form of money, services, favors, etc.

It would jeopardize the effectiveness of Section 16(b) to require the corporation to prove the value of the indirect benefits (which could be substantial), or to prove that the insider was to receive tangible benefits at some point in the future. It would be quite possible for an insider to have an "understanding" with his friends and/or family which could be framed in such a manner as to be easily disguised, or covered up. Likewise, it is difficult indeed to place a dollars and cents value on the substantial intangible benefits which obviously inured to Potter's benefit.

But even if it could be conclusively shown that the insider would receive absolutely no benefits of any kind, the fact would still remain that the insider had controlled and directed the disposition of a substantial sum of money in contravention of Section 16(b), and the other stockholders would have been damaged just as much as they would have been had the insider retained the profits.

II. There Are No "Special and Important Reasons" for Granting the Writ

Even if Potter were correct insofar as his attack on the opinion of the Fifth Circuit Court of Appeals is concerned (and he hasn't), he has completely failed to demonstrate

that there are any "special and important reasons" for writ of certiorari to be granted.

Once the facts are understood it is obvious that Section 16(b) was applied properly, and there is no reason for this case to be reviewed by the United States Supreme Court.

Also, it should be noted that as a practical matter it is highly unlikely that this factual situation will be repeated again for at least two reasons. First, it can be reasonably assumed that relatively few transfer agents make the mistake which was made here, to-wit, the failure to place legends on certificates evidencing the ownership of restricted stock; and, second, if and when a mistake such as this is made in the future, it can also be reasonably assumed that the person, or persons, affected, will not attempt to take advantage of the mistake in the manner Potter did.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for writ of certiorari should be denied.

Respectfully submitted

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